



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

**DRAFT OF SHARIAH PARAMETER
REFERENCE 2: *IJARAH* CONTRACT**

(SPR2)

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1. Overview: Challenge in Implementation of Shariah rulings.....	1
2. Shariah Parameter References Initiative	2
3. Shariah Parameter References Methodology.....	3
4. Notes to Users of Shariah Parameter References	3
5. Applicability	4
6. Appendix.....	5

BNM/RH/CP/012-3	Islamic Banking & Takaful Department	Concept Paper on Shariah Parameter Reference 2: <i>Ijarah</i> Contract (SPR2)	Page 1/4
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1. Overview: Challenge in Implementation of Shariah Rulings

- 1.1 In response to the need for a conducive, sound and stable Islamic financial environment, local and global Shariah governing bodies have formulated Shariah rulings and expressed Shariah opinions in the form of fatwas, resolutions and policies to be adopted by the Islamic financial industry.
- 1.2 An equivocal approach in formulating Shariah rulings for a particular product or financial service that has a wide implication across industry and across sovereignty calls for a more systematic Shariah ruling formulation. This is important if consistent Shariah opinions are to be adopted within or across sovereignty that allows comparison of Shariah rulings.
- 1.3 In implementing Shariah rulings, it is observed that the Islamic financial industry is faced with a number of challenges as follows:-
- a. lack of familiarity and ability to understand Islamic finance concepts;
 - b. lack of published references on how to operationalise Shariah approved contracts from Shariah authorities; and
 - c. lack of publicly available document on fatwa and Shariah resolutions as a source of reference.
- 1.4 It is also observed that implementation of Shariah rulings is limited to product approval and not comprehensive across product development and product life cycle comprising product idea generation, monitoring and supervision.

BNM/RH/CP/012-3	Islamic Banking & Takaful Department	Concept Paper on Shariah Parameter Reference 2: <i>Ijarah</i> Contract (SPR2)	Page 2/4
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2. Shariah Parameter References Initiative

- 2.1 Bank Negara Malaysia is developing a set of standard guidance document on application of Shariah contracts in Islamic finance operation, referred as Shariah Parameters. The initiative is based on the need to outline the essential features of Islamic financial product based on the underlying Shariah contracts that are endorsed by Shariah boards and adopted by the Islamic financial institutions.
- 2.2 The Shariah Parameter References as standard guidance documents would provide a more comprehensive understanding of the principles and basis of adopting Shariah contracts for Islamic financial products, as well as enabling harmonization of the Islamic financial practices.
- 2.3 The development of Shariah Parameter References is aimed at achieving the following objectives:-
- a. To clarify concepts, principles and conditions of Shariah contracts;
 - b. To provide focus on features of Shariah contracts that form the basis of Islamic financial product;
 - c. To provide basis for decisions on matters relating to conditions, mechanism and implementation of Shariah contracts;
 - d. To facilitate Islamic finance professionals and practitioners to design and develop Islamic financial products; and
 - e. To facilitate formulation of policies and guidelines on contracts adopted by Islamic financial service industry
- 2.4 The Shariah Parameter References set out the Shariah requirements for the contracts of *Murabahah*, *Ijarah*, *Mudarabah*, *Musharakah*, *Istisna'* and *Wadiah*. Shariah Parameter Reference 1: *Murabahah* Contract (SPR1) will be issued soon. Concept paper on the parameters for the remaining Shariah contracts will be issued for feedback and comment from time to time.

BNM/RH/CP/012-3	Islamic Banking & Takaful Department	Concept Paper on Shariah Parameter Reference 2: <i>Ijarah</i> Contract (SPR2)	Page 3/4
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2.5 The concept paper on Shariah Parameter Reference 2: *Ijarah* Contract (SPR2) sets out the Shariah requirements for the application of *Ijarah* contract.

3. Shariah Parameter References Methodology

- 3.1 In preparing the Shariah parameters, the following considerations have been made to institute a methodology to develop the parameters:-
- a. Primary sources were given priority over secondary sources in determining the status of a feature or an issue;
 - b. Fatwas were obtained to support the essential features of a particular contract; and
 - c. Deductive and inductive approaches were adopted in formulating the parameters in the context of Islamic financial products and in meeting the needs of the Islamic financial services industry.

4. Notes to Users of Shariah Parameter References

- 4.1 The Shariah Parameter Reference is subject to review from time to time by the Shariah Advisory Council of BNM (SAC). In this respect, relevant Islamic financial institutions are expected to observe the effective implementation date of the Shariah Parameters.
- 4.2 The parameters would assist users to understand the nature of the contract by understanding the definition, legitimacy as well as the purpose of the contract.
- 4.3 The essential features of the contract are clearly outlined in several parts of this parameter to explain the practices in undertaking the contract. The features include among others the contracting parties, the subject matter, the price or rent

BNM/RH/CP/012-3	Islamic Banking & Takaful Department	Concept Paper on Shariah Parameter Reference 2: <i>Ijarah</i> Contract (SPR2)	Page 4/4
-----------------	--------------------------------------	---	-------------

where relevant, profit distribution where relevant, delivery and payment of goods and services.

- 4.4 The parameters also highlight the operational issues relating to the contract to enable users to be aware of the implication of these issues on the product structure. It is important to note that certain issues involving legal matters, operations and risks were made based on resolutions made by majority opinion whilst other issues may have been based on a minority opinion of the scholars or Shariah boards. Where such issue is not deemed conclusive from the Shariah authority, users are expected to refer to the SAC for further guidance.

5. Applicability

- 5.1 This concept paper is applicable to:-
- a. All Islamic banking institutions licensed under the Islamic Banking Act 1983 (IBA);
 - b. All banking institutions licensed under the Banking and Financial Institution Act 1989 (BAFIA) which participate in Islamic banking scheme;
 - c. Development financial institutions prescribed under the Development Financial Institutions Act 2002 (DFIA) which provide Islamic financial services; and
 - d. All takaful operators registered under the Takaful Act 1984 (TA).

6. Appendix

- 6.1 Shariah Parameter Reference 2 : *Ijarah* Contract (see attachment 1)
- 6.2 Feedback Form (see attachment 2)

APPENDIX

TABLE OF CONTENTS

SECTION 1: BACKGROUND AND PREAMBLE	1
SECTION 2: PURPOSE AND SCOPE.....	1
SECTION 3: DEFINITION.....	2
SECTION 4: LEGITIMACY OF <i>IJARAH</i> CONTRACT.....	3
4.1. The <i>Quran</i>	3
4.2. The <i>Sunnah</i> of the Prophet Muhammad (SAW).....	3
4.3. The Consent of Majority of the Muslim Jurists.....	4
SECTION 5: FEATURES OF <i>IJARAH</i> CONTRACT	4
5.1. Usufruct and Services	4
5.2. Assets for <i>Ijarah</i>	8
5.3. Ownership Rights and Liabilities in <i>Ijarah</i> Contract.....	10
5.4. Utilization of Leased Assets.....	14
5.5. Lease Period.....	16
5.6. Lease Amount and Payment.....	16
5.7. Enhanced Features of the Contract	19
Default and Compensation	19
Promise (<i>Wa'd</i>) in <i>Ijarah</i> Arrangement	20
Cancellation and Termination of <i>Ijarah</i> Agreement	21
Selling of Leased Asset	22
Takaful for <i>Ijarah</i>	23
SECTION 6: GLOSSARY	24

SECTION 1: BACKGROUND AND PREAMBLE

1. *Ijarah* or lease is a form of contract which is permissible in Islam based on the textual evidence in the *Qur'an* and the *Sunnah* of the Prophet Muhammad (SAW). Generally, it is a contract of exchange of counter values between usufruct and lease payment/rental rate. Islam has permitted the contract of leasing in order to facilitate the public who do not intend to own certain assets but need to use and benefit from the use of the assets. Islamic law permits the lease of certain assets whose benefits can be obtained by the lessee against the payment of certain agreed rental. Like any other contracts, an *Ijarah* contract has to fulfil all the conditions of a valid contract stipulated by the Shariah. *Ijarah* has emerged as a popular contract of financing among Islamic Financial Institutions (IFIs) for many of their financial products such as property financing, vehicle financing, project financing, personal financing and structured products. These products enable customers to lease the assets based on *Ijarah* from IFI with an option to subsequently own or purchase the assets based on *Ijarah Muntahia bi al-Tamlik* or *Al-Ijarah Thumma al-Bai'* respectively.

SECTION 2: PURPOSE AND SCOPE

2. The purpose of this Shariah contract parameter for *Ijarah* is to provide reference on the nature and features of the contract to the Islamic financial services industry. This parameter will be endorsed by the Shariah Advisory Council of Bank Negara Malaysia. Specific definition and guidelines on the basis of legitimacy in adopting the *Ijarah* contract are described to facilitate the understanding of the Shariah contract requirements. The features identified in this parameter shall serve to assist the Islamic financial services industry to identify, understand, apply and distinguish the contract from other contracts prevalent in the industry.
3. The features identified and described in this parameter are extracted from the text of fatwas opined by Shariah boards or committees of financial authorities and financial institutions. For each of the fatwa on a particular conditionality, activity, situation or context relating to the contract, the underlying concept and principle is deduced and synthesized to guide the development of the Shariah parameter.

4. If a feature of a contract practised is not specified in this parameter and the Islamic financial institutions use an alternative opinion, such feature would require further deliberation by the Shariah Advisory Council of Bank Negara Malaysia to decide on its status.
5. This parameter also takes into consideration relevant mechanisms and contracts such as *Wa'd*, *Wakalah*, *Kafalah* and *Rahn* where relevant. These are identified and proposed as secondary features mentioned in this parameter.
6. The scope of the parameter is confined to the *Ijarah* contract as endorsed by the Shariah Advisory Council of Bank Negara Malaysia adopted by the Islamic financial institutions under the purview of Bank Negara Malaysia.

SECTION 3: DEFINITION

7. *Ijarah* literally means to rent or lease something. In its technical sense, the term *Ijarah* has two different connotations as follows:
 - i. A hire contract to employ the services of a person with wages given to him/her as a consideration for his/her hired services.
 - ii. A lease contract to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him/her.
8. *Ijarah Muntahia bi al-Tamlik* means a lease contract which ends with the transfer of the legal title of the leased asset to the lessee. Effective transfer of the legal title is a consequent to the conclusion of the lease arrangement that can be in the form of a sale or a gift of the asset to the lessee. *Al-Ijarah Thumma al-Bai'* as adopted in Malaysia is a form of *Ijarah Muntahia bi al-Tamlik* where the sale of asset to the lessee is executed at the completion of the lease period.

Ijarah is either the hiring of services or the usufruct of assets.

SECTION 4: LEGITIMACY OF *IJARAH* CONTRACT

9. The legality of *Ijarah* is deduced from the *Qur'an*, the *Sunnah* of the Prophet Muhammad (SAW) and the consensus of the Muslim jurists (*Ijma'*). *Basis of Legitimacy*

4.1 THE *QURAN*

10. Several verses of the *Qur'an* can be quoted as evidence for *Ijarah* particularly for hiring the services of a person. Among others, the verses which mean: And said one of them (the two women): "O my father! Hire him! Verily, the best of men for you to hire is the strong, the trustworthy". He said: "I intend to wed one of these two daughters of mine to you, on condition that you serve me for eight years, but if you complete ten years, it will be (a favour) from you. But I intend not to place you under a difficulty. If Allah will, you will find me one of the righteous." (28:267) *Payment of wages for services rendered in the Qur'an.*
11. The above verses describe the story of the Prophet Musa (a.s) being hired for a certain period of time to undertake a specific task. The compensation for the task undertaken by the Prophet is deemed as payment for the outstanding dowry for his marriage.

4.2 THE *SUNNAH* OF THE PROPHET MUHAMMAD (SAW)

12. Unlike the Quranic verses, the *Sunnah* of the Prophet Muhammad (SAW) refers to both lease and hire contracts as follows: *Ijarah in the Sunnah*
- i. The Prophet (SAW) said: "Pay the hired worker his wages before his sweat dries off". (Sunan Ibn Majah)
 - ii. The Prophet (SAW) is reported to have said: "He who hires a person should inform him of his fee." (Al-Sunan Al-Kubra li Al-Baihaqi)
 - iii. Abdullah ibn Umar narrates, "Allah's Apostle gave the land of Khaibar to the Jews to work on and cultivate and take half of its yield." Ibn 'Umar added, "The land was used to be rented for a certain portion (of its yield)." (Sahih Al-Bukhari)

4.3 THE CONSENT OF MAJORITY OF THE MUSLIM JURISTS

13. *Ijarah* has been unanimously approved by the companions of the Prophet Muhammad (SAW) and prominent jurists of the recognized schools of Islamic law. They view that the need to utilize the usufruct of different articles (goods and services) is similar to the need to utilize the articles. When the contract of sale of such goods and services is permitted, the lease of its usufruct shall also be permitted on the grounds of public interest (*maslahah*) and needs.

Ijarah to satisfy the need of the people

SECTION 5: FEATURES OF *IJARAH* CONTRACT

14. *Ijarah* is a contract that comprises several principal features namely the usufruct and services, asset, ownership and usage rights and liabilities, lease period and rental amount.

Ijarah features are usufruct, services, rental and lease period.

Illustration 1 : Pertinent Elements of the Agreement

An IFI agreed to provide financing facility to lease an asset to the customer. The facility specified the period, schedule of lease payments and a rental rate for the lease. The customer can decide on the type of asset which the IFI will agree and lease using the above facility. Although a leasing facility has been approved, the lease agreement should specify the type of asset as well as the appropriate rental rate. In this case, pre-determined rental rates should be indicative for the different types of assets as the IFI will assume the relevant risk exposures for each type of asset. The lease agreement is then executed between the customer and the IFI only when the purpose of the leased asset, type of leased asset, lease payment schedules, rental rate, lease period as well as whether the asset is to be transferred to the lessee at the end of the lease tenor or otherwise, have been determined.

5.1 USUFRUCT AND SERVICES

15. *Ijarah* applies to both hire of services and lease of a property for wages/fees and rental, respectively. The nature of benefit to the hirer and lessee is the services rendered by person(s) and the usufruct of a property, as the case may be.

16. *Ijarah* may be in the form of hiring of services or labour such as hiring the services of an engineer, a carpenter or a tailor to undertake a specific task in exchange of consideration in the form of fees or wages for the services rendered.

Hiring of services under Ijarah

Illustration 2 : Hire of Services

An IFI provides on-line payment services based on standing instruction by the customer of the IFI. The customer specifies the third party account as well as the amount and frequency of payment to be made. Upon the engagement, direct debit payments are made from the customer's account and the bank earns fees (*ujr*) from such services.

17. *Ijarah* may be in the form of financing for the services rendered by the service provider. These services are offered in exchange for consideration in the form of fee payments. These include services rendered such as educational services, health services and tourism services.

Ijarah can be used for services (Ijarah Al-Ash Khash)

Illustration 3 : Financing For Education Services

A student received an offer from an education institution to enroll for a four-year academic program valued at RM100, 000 with fees payable at RM25, 000 per annum. The student requested for financing from an IFI which leased the academic program from the education institution and subsequently sub-leased it to the student at RM20, 000 per annum payable over a period of five years.

18. *Ijarah* may be executed on the utilization of the usufruct of tangible assets by transferring the right to use the usufruct of a specific asset to the agreed lessee for a specific period of time and for an agreed rental amount.

Usufruct of tangible assets (Ijarah Al-Ayn)

Illustration 4 : Leasing of Assets

An Islamic bank is approached by a corporate customer to finance an operating lease of equipment. The bank appoints the customer as an agent to obtain quotation for the purchase price of the equipment at market price or a fair value at RM 50, 000. Prior to the purchase of the equipment by the bank, the bank secured an undertaking from the customer to lease the equipment from the bank. The bank purchases the equipment and leases the asset to the customer for a specified period with either a fixed or a renewable rental payment of RM 15, 000 for 5 years. The rental income is reflective of the usage of the equipment during the specified period. At the end of the financing period, the asset can be disposed at market value to a third party. If the customer intends to purchase the equipment, a purchase option is executed as per the lease agreement. For example, at the end of the third year, the equipment could be sold to the customer at the price of the remaining outstanding lease payments of RM 30, 000.

19. IFIs have adopted two modes of *Ijarah* which are the operating lease and the structured operating lease, that is, lease with transfer of ownership to lessee, which is also known as *Ijarah Muntahia bi al-Tamlik*. *Operating lease and structured operating lease in IFI.*
20. The subject matter of *Ijarah* may be an existing usufruct as well as usufruct to be established in the future known as *Ijarah al-Mudhafah ila al-Mustaqbal* or *Ijarah Mawsufah fi al-Zimmah* as the case may be. *Existence of usufruct*
21. A usufruct may be leased out provided the usufruct is already in existence upon execution of contract and is expected to continue during the *Ijarah* period.

Illustration 5 : Forward Lease

An IFI enters into a two year forward lease agreement with a university to finance the construction of hostel accommodation by a developer. The project value is determined and disbursed to the developer based on *Istisna'* financing for RM 2 million. Services rendered by IFI during the period of construction require the university to make annual lease payment of RM 100, 000 based on forward *Ijarah* to the IFI. Upon completion of the property construction, the IFI recognizes the lease payment as revenue and enters into a lease contract with the university to lease the asset for the next 5 years.

22. *Ijarah Mawsufah fi al-Zimmah* is a form of *Ijarah* where the asset needs to be described in detail in advance but is not available at the time of the contract. The asset must be delivered on a future agreed date. *Forward Ijarah; specified future usufruct to be leased out*
23. Asset which cannot be described in detail does not qualify as an asset under *Ijarah Mawsufah fi al-Zimmah* as it falls under *Ijarah li Ma'dum*.
24. In *Ijarah Mawsufah fi al-Zimmah*, the rental payable may be fixed or varied according to an agreed benchmark for a specified period and shall be determined when the contract is concluded. *Linkage of rental and usufruct*
25. The rental payment for Forward *Ijarah* may be in a single or on a staggered basis as agreed by both parties.
26. The rental amount received by financier shall be earned only upon effective delivery of the usufruct of the leased asset to the lessee.

Illustration 6 : Effective Delivery of Leased Asset

A property development company seeks financing to lease an equipment from an IFI. The equipment needs to be installed at the company's construction site prior to the lease as specified in the *Ijarah* contract. The IFI acquired the equipment and leased the asset to the company without installation. Although the IFI had purchased the equipment to lease to the company, they have no capacity to lease the equipment as the equipment is not installed. Hence, effectively the lease agreement is not effective until usufruct is established upon installation.

27. The rental amount received by financier shall be refunded to the lessee if the asset cannot be effectively delivered to the lessee for the agreed period.
28. In relation to paragraph 27, upon completion of the leased asset under a forward lease and prior to enjoyment of the usufruct, the lessee may purchase the leased asset and the forward rental amount may be treated as part of the selling price.

5.2 ASSETS FOR IJARAH

29. The leased asset may be tangible or intangible assets such as trademark, patent and other forms of intellectual property. Tangible assets shall be non-perishable (durable). The tangible asset may be movable or immovable.

Non-consumable assets of both immovable and movable assets

Illustration 7 : Permissible Asset for Lease

A fast food operator seeks financing from an IFI for the food business comprising stock of food, the store and the brand name of the principal operator. A lease contract drawn between the IFI and the customer applies only to the store and brand name. The stock of food does not qualify for lease as it is perishable and consumable.

30. The leased asset shall be specified and be clearly identified by the contracting parties.

Identification of the leased asset

Illustration 8 : Specification and Identification of Leased Asset

Company A enters into an *Ijarah* agreement to lease a shop situated in Menara V. The lease contract stipulated all the details of the agreement such as the rental, the location in the Menara V etc., except that it did not specify the exact lot of the shop within Menara V which is the subject matter of the agreement. Such agreement is deemed to be void as the subject matter is not clearly identified in the lease contract.

31. The leased asset held in common between the financier and the lessee or among the partners such as financier with a third party may constitute a partnership in a non-divisible asset. Where the partnership leases the asset, each partner lessor shall jointly own the asset and have the right to benefit from the part claim on the rental payment for the leased asset based on proportionate share in the leased asset.
32. A client may, jointly with an IFI, acquire an asset from a third party. The client subsequently leased the asset from the IFI. In such an arrangement, the rental payment to the IFI shall proportionately reflect the lease value of the IFI's ownership in the asset.

Jointly owned asset as the subject matter of Ijarah

Joint acquisition of asset by IFI and client.

Illustration 9 : Jointly Owned Asset Leased to One of the Partner

An Islamic bank and a trading company jointly purchase a shop house from a third party. The bank signs an annually renewable tenancy agreement with the trading company and in a separate contract, the trading company agrees to purchase a share of the asset annually at a certain market price. The purchase is conducted during the same period of the tenancy. During the lease period, the rental amount declines in according to the asset share owned by the bank. At the end of the lease period, the asset is fully owned by the trading company.

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|---|---|
| 33. The lessor shall be liable for all expenses incurred in acquiring the leased asset. These expenses shall be included as the acquisition cost of the asset and may be taken into consideration in pricing the rental rate. | <i>Consideration of purchase expenses in the rental rate</i> |
| 34. Shares in a company shall not qualify as leased asset of <i>Ijarah</i> . | <i>Shares do not qualify to be leased</i> |
| 35. The leased assets shall be with the lessor though the registration of the title may be in the name of the lessee. | <i>Ownership and possession of asset</i> |
| 36. The leased asset may be registered under the name of the lessee provided all liabilities arising from ownership of the leased asset shall be borne by the lessor. | <i>Registration of the asset under the name of the lessee</i> |
| 37. The lessor (financier) shall purchase the asset to be leased or alternatively, may appoint the lessee (customer) as an agent to purchase such asset on the financier's behalf. | <i>Purchase of leased asset by the lessor or purchase via agency</i> |
| 38. As a purchasing agent, the lessee shall not be held liable for any damage or defect not due to his negligence while purchasing the asset on behalf of the lessor. The liability of the lessee shall commence when the lessee takes delivery of the leased asset for acquiring the benefit of the usufruct. | <i>Liability of purchasing agent vis a vis lessee</i> |
| 39. The existing lessor may sell the leased asset with existing lease arrangement to a new lessor. The conditions of contract remains until expiry of the lease period and all the rights and obligations of the lessor shall be transferred to the new owner. The third party as lessor then shall have the right to collect the rental from the lessee. The existing lessor may manage the leased asset, collect the rental on behalf of the new lessor and also undertake to guarantee the payment of the rentals by the lessee. | <i>Continuation of a lease contract despite the change in ownership</i> |

40. Financier may purchase an asset from a customer with the purpose to lease it back to the customer. Both the purchase and lease contracts are executed separately and consecutively. *Sale and lease back*
41. The lessee may lease back the leased asset to the lessor at any rental amount provided that the two leases are two separate and independent lease contracts.
42. The lease back arrangement may be for a different rental amount when there are some improvements or changes made to the leased asset prior to the lease-back transaction.
43. In relation to paragraph 41, the lease and lease back is only permissible if the preceding lease contract is for a longer period and the sub-lease is for a shorter period.
44. A property jointly owned by two or more persons can be leased out to third party and the rental shall be distributed between the joint owners according to the proportion of their respective shares in the property as stated in 31. *Leased of jointly owned property*
45. Notwithstanding 44, a joint owner of a property may mutually agree to lease the proportionate share of the property to a co-owner only, and not to any other person.
46. A customer's share in an asset jointly owned with the IFI may be pledged to the IFI as security.

5.3 OWNERSHIP RIGHTS AND LIABILITIES IN IJARAH CONTRACT

47. The rights and liabilities arising from the ownership of the leased asset shall be with the lessor while the rights and liabilities arising from the use of the leased assets shall be with the lessee. *Ownership liabilities and usage liabilities*
48. The leased asset in the lessee's actual or constructive possession shall be a form of trust (*amanah*). There shall not be compensation by the lessee to the lessor in case of impairment of the asset value, except when such impairment is caused due to the negligence or misconduct of the lessee. *Leased asset as a trust*
49. Any loss or impairment relating to a leased asset shall be borne by the lessor throughout the lease period due to factors not caused by negligence or misconduct of the lessee. *Impairment loss not caused by the lessee*

50. In a situation where the usufruct of the leased asset is impaired wholly or partially as a result of the lessee's misconduct or negligence, the lessee shall be responsible for restoring the usufruct and bears such cost including the rental charges payable during the restoration period. *Impairment loss caused by the lessee*

Illustration 10 : Restoration of Usufruct by Lessee

A new lorry is leased by an Islamic bank to a freight company for two years. During the lease period, excessive load was carried that damaged the suspension on the vehicle. The freight company is liable to restore the lorry, continue to lease the lorry during the remaining lease period and pay the full lease payment for the period.

51. If the usufruct of the leased asset is impaired wholly or partially as a result of a natural cause or other reasons and there is no negligence on the part of the lessee, the lessor shall be responsible for restoring the usufruct and bears such cost. The rental charges payable from the lessee during the restoration period shall be waived. *Restoration of usufruct due to natural impairment*

Illustration 11 : Loss Resulted From Natural Causes

Construction equipment which was leased to a contractor by an IFI was damaged due to unprecedented soil movements at the construction site. The equipment needs to be replaced or repaired. The bank as the lessor shall bear the cost of replacement or repair and the lease payment is suspended until the equipment is ready to benefit the lessee for the purpose of which the lessee has entered into the lease arrangement.

52. Any expenses in the ordinary course of business that relate to maintain the capacity or structure of the usufruct of leased asset shall be borne by the lessor as ownership risk is vested with the lessor. These include expenses related to wear and tear and natural causes which are not due to the lessee's misconduct or negligence. Impairment of capacity or structure of lease asset through non-maintenance of such assets may render the contract voidable.

Illustration 12 : Major and Ordinary Maintenance of Leased Asset

MYIJARAH CAR rental leases a car to a company for one year. A clause in the agreement states that the lessee shall maintain the car in its operating condition such as ongoing regular engine oil change. In the event of lack or no maintenance, the lessee is liable for violating the condition of the contract. In the event of a need for major maintenance such as replacing the engine mounting during the lease period, the lessor is responsible to provide such maintenance and compensate for any loss of use during such period by either waiving the rental payment or replacing with another car during the repair period.

53. Any operational maintenance and expenses relating to the usage of the leased asset shall be borne by the lessee who acts on a fiduciary relationship to safeguard the interest of the lessor. *Operational maintenance*
54. When major maintenance of the leased asset is delegated to the lessee, all costs incurred for such maintenance shall be reimbursed by the lessor. *Reimbursable expenses*
55. The lessor may agree with the lessee that the lessee bears the takaful cost provided that the cost is reimbursable from the lessor. *Lessor liability for takaful cost*
56. A leased asset may be sub-leased to a third party unless it is stated otherwise in the primary lease contract. *Sublease to third party*
57. The sub-lease shall be valid for the period not exceeding the tenure of the primary lease contract.
58. Rental payment for the asset that is sub-leased may be the same amount, higher or lower, payable on the spot or on a deferred basis, unless it is stated otherwise in the primary lease contract. *Characteristics of rental payment for sub-lease*

Illustration 13 : Sub-Lease of Asset

A holding company entered into a lease agreement (the agreement) on an office building with an IFI and planned to sub-lease the office to its subsidiaries. A provision in the agreement allows for sub-leasing provided that the tenant activities are Shariah compliant. Upon assessment, the IFI is satisfied that the tenant activities are Shariah compliant. Thus the holding company's plan can be executed. Relevant terms and conditions in the agreement that will safeguard the lessor's interest apply to the sub-lease agreement.

59. The modes of transfer of the leased asset in *Ijarah Muntahia bi al-Tamlik* may be by way of a gift or a sale of the leased asset. *Lease followed by transfer of leased asset to lessee*
60. The ownership of the leased asset shall be transferred to the lessee upon execution of a sale contract of the leased asset as promised (*Wa'd*) by the lessor at a mutually agreed consideration to be executed at the end of the lease period or at any time during the lease period. *Transfer of asset title via sale contract*
61. The transfer of the leased asset may be effected in the form of a gift deed by the lessor to the lessee as *Hibah* upon fulfilment of the condition that all *Ijarah* instalments are fully settled. *Transfer of asset as gift*

Illustration 14 : Lease Followed by Sale of Asset

Due to the rising property prices and the need to possess and occupy an office building, a customer agreed to lease a property from an IFI for a period of 10 years. In the lease agreement, the bank provides an option to the lessee to purchase the property during or at the end of the lease period. The rental rates are reviewed every two years. In the sixth year, the customer exercises the purchase option to mitigate further significant increase in rental rates.

62. A lease contract may be entered between the purchaser and the seller subsequent to the sale. In this arrangement the seller shall promise to lease the asset from the purchaser when the sale is executed. In such an arrangement, all the conditions and obligations of the *Ijarah* contract apply to the seller as lessee and the purchaser as lessor. *Lease contract subsequent to sale contract.*

Illustration 15 : Sale and Lease Back

Company ABC buys a plot of land from XYZ Poultry Sdn. Bhd. and promises to lease it back to XYZ Poultry Sdn. Bhd. After the selling of the plot is concluded, Company ABC enters into a separate lease contract to lease the plot of land to XYZ Poultry Sdn. Bhd. for a period of twenty years.

5.4 UTILIZATION OF LEASED ASSETS

63. The transfer of usufruct of leased asset from lessor to lessee is valid from the Shariah perspective. However, the permissibility to lease an asset shall be based on the permissibility of core activity of the lessee though it may involve some activities which are not Shariah compliant.

Core permissible activity

Illustration 16 : Principal Activity of Leased Assets

Bank ABC leases an aircraft to Airline DEF over a period of twenty years. Airline DEF utilizes the aircraft for transporting passengers to different destinations across the globe. On board the plane, Airline DEF serves alcohol to its passenger. The fact that Airline DEF serves alcohol on board does not invalidate the lease contract between Bank ABC and DEF because the main purpose of the lease is transportation of passengers. However, if the aircraft is leased for the sole purpose of transporting liquor, then the lease contract is not permitted.

64. The lessee shall observe the terms and conditions of the utilisation of the leased asset until the expiry of the lease period or the termination of the lease as agreed by both parties, whichever is earlier.
65. The lessee shall use the leased asset only for the purpose specified in the lease agreement.

Observance of terms and conditions

Designated purpose of use

Illustration 17 : Permissibility of Usage of Leased Assets

Airline "A" leases a passenger aircraft from Company "E". After using the aircraft for several years, Airline A intends to convert the aircraft to a cargo aircraft to transport goods. Airline A has no right to do so without the permission from the owner of the aircraft which is Company E.

66. If the agreement does not specify the purpose of the lease, the lessee may use the leased item for whatever permissible purpose according to the customary practice of the market (*'urf*).

Guidance of customer's practice for the usage

Illustration 18 : Usage of Leased Asset not in Accordance with Specified Purpose

A fleet of container lorries designed to transport non-perishable manufactured goods was leased by a trading company to transport manufactured electronic components. In one instance, the company had to transport livestock that arrived at the port to a particular destination since the shipment arrived earlier than anticipated. In transporting the livestock, the container was damaged and some of the livestock died and injured. The company has violated the specified purpose condition and is liable for breach of contract and losses incurred by the lessor.

- 67. The lessee shall obtain permission from the lessor if the leased asset is to be used for permissible purposes other than its common utilisation according to the customary practice (*'urf*). *Consent of the lessor for non specified use*
- 68. The asset shall not be leased to a person or entity if it is known or if there is a very high probability that the leased assets are to be used for non-Shariah compliant activities. *No lease for potential non-compliant use*
- 69. The lessee shall be liable for any variation from the permissible use of the leased asset for a purpose which is against the Shariah. In such a case, the lessor may terminate the contract or seek other legal recourse as a remedy for the breach. *Implication of non-compliant usage*
- 70. The terms and conditions on the use of the leased asset specified by the lessor may allow the lessee flexibility to increase, enhance, extend or expand the use of leased asset including lease payment considerations. *Flexible use of leased asset*

Illustration 19 : Contract Variant in Usage of Leased Assets

An IFI enters into a lease contract with a courier company to transport specific volume of goods at a specific rental rate for a specified period. It is agreed by both parties, in case where the volume exceeds the agreed volume in the contract, the lessor is entitled for additional rent from the excess volume at a higher rental rate agreed by both parties. The two-tier rate is agreed and specified to enable flexibility in the lease agreement.

- 71. The lessee shall be liable to compensate the lessor in the event of any malfunction or impairment of the leased asset which negates the usufruct of the asset due to lessee's misuse or negligence. *Lessee shall compensate lessor for asset impaired due to lessee's negligence.*

5.5 LEASE PERIOD

72. The period of lease shall be agreed and specified as per the terms of the contract. *Defined lease period*
73. The lease period shall effectively commence from the time the lessee has the access to the usufruct of the leased asset regardless of whether the lessee has actually utilized the asset. *Commencement of lease period*
74. The lease period shall terminate at maturity of the period or in the event that the asset is impaired in terms of its function or utility or when both parties mutually agree to rescind the contract. *Termination of lease period*

5.6 LEASE AMOUNT AND PAYMENT

75. The rental payment may be made in cash, kind or in the form of services. *Rental in cash, kind or services.*

Illustration 20 : Lease Payment in Services

ABC Cleaning Services Sdn. Bhd. which operates cleaning services leases an office space from XYZ Holdings. The rental of the office space is RM20, 000 per month. At the same time, XYZ Holding engages ABC Cleaning Services Sdn. Bhd. to provide cleaning services for its premise and the contract value for such services equals to RM20, 000 per month. XYZ Holdings agree to accept the cleaning services provided by ABC Cleaning Services Sdn. Bhd. as the lease payment of the office space.

Illustration 21 : Lease Payment in Kind

A property owner granted permission to another party to build and to subsequently lease the building from the owner for a definite lease period. During the lease period the party benefited from the occupancy of the building and the use the land without any payment made to the owner. At the end of the lease period, the building and land were returned to the owner. Hence, lease in form of benefit in kind can be mutually agreed between the property owner and the lessee.

76. The rental or lease amount shall be determined upon acceptance of the offer of the lease contract. *Determination of rental upon establishment of contract*

77. The amount of rental specified and mutually agreed for the lease period shall not vary during the period. Any variation such as rental benchmarked to market rate or index is prohibited. However, a periodic review of the rental amount may reflect the market rate or any agreed benchmark upon renewal of contract for subsequent lease periods.

Certainty of rental amount

Illustration 22 : Variable Rate

In view of the uncertain economic conditions and volatile market prices, an Islamic bank is prepared to lease a property with the rental amount reviewed every two years based on market rental rates to a tenant with an option to purchase the property during or at the end of the lease period. The master agreement specified that the lessee is prepared to lease the asset for 10 years with bi-annual review of the rental amount. The lease contract is renewable every two years. In this manner, the overall rental rate reflects the market rental rates during the lease period.

78. The rental amount may vary on a daily basis provided that such variation is based on benchmark made known and agreeable to both parties.
79. In a leasing agreement whereby the leasing period is divided into a number of phases, the rental rate specified in each phase may vary for different phases during the lease period, provided that the amount of rent for each phase shall be specifically agreed upon at the time the lease takes effect.
80. A rent adjustment clause may be inserted into the *Ijarah* contract in order to facilitate the multi-phase rates of *Ijarah* for renewal in subsequent phases. The rental rate adjustment for the rental amount may be in form of a specified rent escalation or may be indexed to a certain index indicator, such as the consumer price index (CPI) or any other benchmark or may also be adjusted according to a certain percentage at the end of an interval of a specific period.
81. No rental payment may be collected or received or earned until the usufruct is established and transferred to the lessee.

Variation of rental

Modes of rental rate adjustment

Rental commences when usufruct is transferred to lessee.

- 82. Rental payment or any part thereof received in advance at the beginning of the tenor of the lease or before effective delivery of the asset to the lessee is permissible and shall remain a liability until the usufruct is established and transferred to the lessee. The advance rental shall be adjusted towards the rent earned after lease payment is due.

Advance payment of rental
- 83. Security such as charge over assets or a third party guarantee may be required from the lessee to secure rental payment.

Guarantee against rental
- 84. In case of foreclosure of the charged asset, the lessor may recover unpaid rental for usage of the leased asset from the proceeds of sale of the security.

Proceeds from the foreclosure
- 85. The IFI may credit some amount of money to the account of the lessee under *Ijarah* as a *Hibah* for timely payment of all the rental payments.

Hibah for timely payment of rental

Illustration 23 : Periodic Review of Rental Rate

In a lease agreement, the lessor in anticipation of future appreciation of property prices specified a rental adjustment clause that allows for periodic review of the rental rate during the construction and leasing of the property.

During the two year construction period, the lease payment is specified based on a fixed rental rate. Subsequent to the completion of the property, the rental rate formula is executed to determine the rental rate subject to review every two years. For example, a fixed lease payment of RM10, 000 per month is agreed during the lease period. Subsequent to the construction period, lease payment of RM15, 000 per month is agreed for two years and the lease renewal is subject to the property price appreciation. Upon renewal, the property value has appreciated by 20% and the lease payment is adjusted to RM18, 000 per month.

- 86. The lease shall be invalid if the rental amount or rate in any executable phase of the lease period is not determined or has been left at the option of the lessor.

No determination of rental amount/rate
- 87. The lessor shall not increase the rent unilaterally. Any pre-agreement to give this right to the lessor will render the contract null and void.

No unilateral rental adjustment
- 88. The lease payment may be in instalments or in lump sum subject to the agreement by the contracting parties.

Mode of rental payment

89. The lease payment shall immediately become due as per the terms and conditions of the agreement or as per the lease payment schedule.
90. If the lessee ceases to utilize the leased asset and returns it to the owner without the latter's consent, the lessor shall have the right to demand the rental payment until the end of the lease period. During the remaining period, the lessor shall not be allowed to lease the asset to another party.
91. An *Ijarah* contract may be executed on the same tangible asset in different mutually exclusive periods and by different lease contracts. Thus two contracts shall not be executed with respect to the same asset for the same period. *No concurrent lease contracts over the same asset*

5.7 ENHANCED FEATURES OF THE CONTRACT

DEFAULT AND COMPENSATION

92. Any outstanding rental payment of an existing *Ijarah* contract as a result of default shall be deemed as debt due from the lessee and shall be subject to all the rules prescribed for defaults and delinquencies in the payment of debt for the defined lease period. The lessor shall not charge any additional amount as income in case of delays in payment of the rental. *Default and compensation*
93. Any compensation for actual loss incurred as a result of the default and delinquencies in payment of debt may be claimed by the lessor.
94. IFI may claim any legitimate compensation caused by breach of contract by the lessee from the cash proceeds of sale of the security. *Compensation via security proceeds*
95. IFI may include a clause in the *Ijarah* contract, stipulating a "compensation for late payment" as determined by the relevant authorities, which is claimable by the IFI from the customer as income or a clause stipulating penalty which shall be channelled to charity. The IFI may also require the customer to prove claim of non-delinquent insolvency in order to be exempted from penalty. *Penalty imposed to be channelled to charity*

Illustration 24 : Default Risk and Mitigation

A lessee who signed a lease agreement with an IFI is not able to make timely payment of the lease payments during the lease period. As a result of the late payment, a penalty was imposed to deter the delinquent behavior. At the end of the lease period, the lease is not renewed and the lease amount outstanding including penalty charges becomes an outstanding debt. In case of non-payment, the IFI can resort to the guarantor (if specified) for such non-payment of an outstanding debt.

96. The lessor may seek compensation for any loss caused by misuse or negligence on the part of the lessee.

Lessee to compensate lessor for misuse or negligence

PROMISE (WA'D) IN IJARAH ARRANGEMENT

97. The *Wa'd* (unilateral promise) by the lessee to lease the asset from the IFI upon the latter's acquisition of the asset shall be binding on the lessee.

Wa'd from customer to purchase asset from IFI

98. The *Wa'd* shall be separately executed prior to the execution of *Ijarah* contract.

99. The IFI may require the customer to pay a security deposit as a guarantee which protects the IFI from the risk of the customer not fulfilling the unilateral promise to lease the asset upon purchase by IFI.

Security deposit as guarantee

100. In a situation where a breach of promise occurs, the IFI may set-off the actual loss from the amount of security deposit.

101. In a situation where there is no breach of promise, the security deposit may be used to set-off part of the rental payment of the leased asset.

Security deposit can be set off as part of rental payment

Illustration 25: Promise to Lease From Lessee

Ahmad requests from Al-Islamic Bank ('bank') to purchase machinery and subsequently promise to lease the machinery from the bank. The bank requires Ahmad to pay security deposit of RM10, 000. Upon the bank's acquisition of the asset, Ahmad refuses to lease the machinery from the bank. In such a situation, the bank can dispose the asset and claim for any loss in value from such disposal as well as other costs incurred due to failure to fulfill the promise. The loss in value and related costs shall be compensated by setting off the security deposit. Any balance from the security deposit shall be returned to Ahmad. If Ahmad proceeded with the lease contract, the security deposit can be considered as part of the lease payment due to the bank.

102. The lessor may promise to sell the lease asset to the lessee at a mutually agreed price. *Promise to sell leased asset*
Alternatively the lessee may promise to purchase the leased asset from the lessor at a mutually agreed price.

CANCELLATION AND TERMINATION OF *IJARAH* AGREEMENT

103. The *Ijarah* contract is a binding contract; neither party may terminate the contract without the consent of the other party. Hence, any option clause for the lessor to terminate the lease without the consent of the lessee shall not be valid except in the case of breach.
104. The lessor may terminate the *Ijarah* contract unilaterally for any violation or breach of any term of the agreement by the lessee. *Unilateral termination by lessor due to breach by lessee.*

Illustration 26 : Lessee Liability Resulting in Termination

Kenari Tourism Sdn. Bhd. leases ten buses for one month from XYZ Transportation Company to ferry tourists to different destinations. The buses were handed to Kenari Tourism after the signing of the lease contract with all the buses functioning well. After ten days of using the buses, one of the buses was grounded as the engine was severely damaged and could not be repaired. Another bus was vandalized as Kenari Tourism parked the buses at an unsecured place. For the first scenario, in which one of the bus was not functioning, Kenari Tourism shall terminate the lease contract for the said bus as the usufruct has ceased to be in existence and in the second occurrence, Kenari Tourism has to bear the cost of repairing the vandalized part as it happened due to their negligence.

105. An *Ijarah* contract may stipulate an option for either or both parties to confirm or rescind the contract during a specific period of time agreed upon by both contracting parties. *Parties have option to confirm or rescind contract.*
106. Upon termination of any *Ijarah* contract as per the agreement or mutually agreed by both parties, the rental for the remaining unutilized period of *Ijarah* shall not become due from the lessee. The lessee shall be required to pay rental up to the date of termination. This is due to the fact that the contract has come to an end and the lessor has no right to collect any rental. *Lessee's obligation to pay rental is up to termination of contract.*

107. Upon the death of either of the contracting parties of an *Ijarah* contract, the legal heirs may then exercise the right to continue or to terminate the contract. The heir may terminate the contract if the continuation is a liability for the heirs beyond their capability to shoulder or that the usefulness of the leased item to the heirs ceases to exist. *Ijarah contract may survive death of party*
108. In case where the leased asset or agreement cannot render the benefits due to the lessee, the lease agreement may continue if the lessor can provide an alternative asset to be leased agreeable to the lessee. Alternatively the lease contract shall be terminated. *Subject to lessee's agreement lessor can provide alternative asset to the impaired lease*
109. A lease arrangement may be renewed by signing a new contract with revised conditions and details. *Renewal can be with an express provision.*
110. The contract may also be renewed automatically, by adding a provision in the *Ijarah* contract that such a renewal shall take place with existing conditions when the existing period lapses unless either party expresses their intention to end the contract. *Automatic renewal of contract.*

SELLING OF THE LEASED ASSETS

111. The lessor may sell the leased asset to any other party except in the case of promise to sell the asset to the lessee. *Leased asset may be sold to lessee or third parties.*
112. The lease agreement shall be terminated upon the conclusion of the sale contract between the lessor and the lessee and the legal title of the asset shall be transferred to the lessee. *Lease contract terminates upon signing of sale contract.*
113. Unless agreed otherwise, the lessor is not required to ask the permission of the lessee if the leased asset is sold to a third party during the period of the lease. *Lessee's permission is not required during lease period.*
114. In the case where a third party as purchaser was not informed of the existing lease agreement on the asset prior to the execution of such a sale, the purchaser may rescind the sale contract. *Rescission of sale contract.*

TAKAFUL FOR IJARAH

115. The lessor may mitigate other specific risks relating to physical damage, theft and/or loss on destruction of the leased asset by participating in a takaful scheme. The cost shall be borne by the lessor. *Lessor's risks can be mitigated with takaful scheme.*
116. The lessor may include the cost of the takaful contribution in the *Ijarah* rental which is subject to a periodic rental rate review including any escalation in the takaful contribution. *Inclusion of Takaful cost in new rental payment*
117. The takaful coverage for the leased asset shall be borne by the lessor as the owner of the asset; however, the lessor can delegate the task of payment of the takaful contribution to the lessee with a provision that this amount shall be reimbursed from the lessor. *Takaful coverage is borne by lessor.*

SECTION 6: GLOSSARY

Terms	Definition
<i>`Urf</i>	Customary practices which are in compliance with Shariah.
Acquisition Cost	Cost to purchase or acquire an asset including its price and direct expenses.
Actual Possession	Physical control over a material object, or occupation of a real property.
<i>Al-Ijarah Thumma Al-Bai</i>	A contract of lease which subsequently followed by a sale contract.
Constructive Possession	A state where a person does not have actual possession, but has the legal rights to control an asset.
<i>Hibah</i>	Gift.
<i>Ijarah Al-Ma'dum</i>	Lease of non-existent and non-specified asset.
<i>Ijarah Al-Mudhafah Ila Al-Mustaqbal</i>	A lease contract that will take effect at a specified future date.
<i>Ijarah Mawsufah fi al-Zimmah</i>	Lease of specified future usufruct of an asset which is not in existence at the time of contract.
Intangible Assets	An identifiable non-monetary asset without physical substance.
<i>Istisna'</i>	A contract of sale of specified assets to be manufactured or constructed, with an obligation on the part of the manufacturer or builder (contractor) to deliver them to the customer upon completion.
Market Rate	The prevailing benchmark/reference rate available at any given time.
Operating Lease	A lease contract which the lessee does not have the intention to own the asset.
Operational maintenance	Maintenance in relation to common usage of the leased asset.
Tangible Assets	An asset that has a physical form.
Usufruct	Benefits of an asset which can be enjoyed by a person without altering the substance of the asset.
<i>Wa'd</i>	Promise or undertaking.